

***United States Court of Appeals
for the
District of Columbia Circuit***



**TRANSCRIPT OF
RECORD**

No. 4768.

S. Naitore & company,
vs. Appellant.

Commissioners of Internal
Revenue.

Additional Authorities.

S. NAITOVE & COMPANY
Appellant

v.

No. 4768

COMMISSIONER OF INTERNAL REVENUE
Appellee

Memorandum of cases cited on argument by counsel for the
Appellant but not included in Brief

American Code Company, Inc., v. Commissioner of Internal Revenue,
Circuit Court of Appeals, Second Circuit, January 14, 1929.
30 Fed. (2nd) 222.

United States v. White Dental Manufacturing Company, 274 U.S. 398.

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Court of Appeals

of the District of Columbia

No. 4768

Henry H. Hodges
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S. NAITOVE & COMPANY, INC.,

Appellant,

VS.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

BRIEF FOR APPELLANT

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Court of Appeals

of the District of Columbia

S. NAITOVE & COMPANY, INC.,
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VS.

COMMISSIONER OF INTERNAL
REVENUE,
Appellee.

No. 4768

BRIEF FOR APPELLANT

Statement of the Case

This is an appeal, taken on March 23, 1928, from a decision in this cause by the majority of the Board of Tax Appeals entered on October 10, 1927, from which decision six members of the Board dissented. The parties have stipulated that said decision may be reviewed by this Court in accordance with the provisions of Section 1002(d) of the Revenue Act of 1926 (R. 31).

The appellee, respondent below, mailed to the appellant, on August 19, 1925, a final notice of a deficiency in income and profits taxes for the calendar year 1919 in the amount of \$59,049.33 (R. 10). On October 17, 1925, the appellant filed its petition with the Board below requesting a re-determination of said deficiency (R. 2-11). After

joinder of issue and hearing duly had on January 19, 1927, the Board, on October 7, 1927, promulgated its Findings of Fact and Opinions therein, as follows:

“FINDINGS OF FACT

“The petitioner is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 725 Broadway, in the City of New York. Its business is that of buying and selling woolen, silk, and cotton goods.

“Samuel Naitove, petitioner’s president, was general executive in charge of the business, and during the year 1919 he owned 85 per cent of the outstanding capital stock. The remaining 15 per cent of the outstanding capital stock was owned by Herbert H. Rabiner, a member of the Board of Directors.

“Petitioner had five employees who held important positions and who constituted the entire staff of the business for the purpose of buying and selling. One of these employees did all of the buying in his department, another assisted the president of the company in buying in the department over which the president gave personal supervision, two others were efficient salesmen, and another handled all of the credit matters.

“These employees were dissatisfied with the compensation being paid to them by the petitioner, and they informed the petitioner’s president that they were contemplating going into business for themselves. In

order that those employees would remain with the petitioner an agreement was entered into between the petitioner and the employees, by which agreement they would, under certain conditions, participate in the profits of the business. This agreement was expressed in a resolution passed by the Board of Directors of the petitioner on February 10, 1919, as follows:

“ ‘Resolved: That additional compensation for the year 1919 be paid to the following officers and employees of the company in accordance with the practice of the company on the following basis:

“ ‘Mr. Moe Naitove, 10 per cent of the net profits for the year 1919; Mr. Nat Naitove, 10 per cent of the net profits for the year 1919; Mr. Jack Naitove, 10 per cent of the net profits for the year 1919; Mr. Moe Turman, 5 per cent of the net profits for the year 1919; Mr. George Naitove, 5 per cent of the net profits for the year 1919.

“ ‘Provided, however, that any and all sums to which the above-named officers and employees may become entitled under the terms of this resolution shall remain in the business at the risk of the business for a period of five years, and that prior to the expiration of such period said officers and employees shall be entitled to demand and receive payment of the sums to which they may become entitled only to the extent that drawings against such sum may be authorized by the president of the company, it being the intention of this resolution that any and all contingent compensation to which said officers

and employees may become entitled under the terms of this resolution, be at the risk of the business in the sense that it shall be subject to pro rata deductions in the event that losses are incurred by the business during the period within which such sums are to remain at the risk of the business; and provided, further, that no officer or employee shall at any time be entitled to withdraw any sums credited to him under the terms of this resolution, except as hereinabove provided, unless he shall remain in the employ of S. Naitove & Co., Inc., during the entire period during which the credits mentioned are to remain at the risk of the business, and in the event of the discharge of any such officer or employee or withdrawal during such period, all right, title or interest of such officer or employee in or to any sums credited to said officer or employee under the terms of this resolution shall revert to this corporation.'

"The petitioner kept its books of account on an accrual basis of accounting and pursuant to the above-quoted resolution the following entry was made in closing the petitioner's books as of December 31, 1919, which entry was correctly computed:

Charge, selling and commis-	
sion	\$116,548.44
Credit Moe Naitove	\$29,137.11
Nat Naitove	29,137.11
Jack Naitove	29,137.11
George Naitove	14,568.56
Moe Turman	14,568.55

additional compensation as per agreement.

“The compensation provided for in the above-quoted resolution and which was accrued on petitioner’s books, was reasonable for the services rendered by those employees in the year 1919.

“In the year 1920, a resolution, similar to that of February 10, 1919, was passed by the petitioner’s Board of Directors, continuing the compensation for services rendered in 1920 on the same basis as authorized for services rendered in the year 1919.

“In the year 1920, the petitioner suffered a loss of approximately \$90,000, and pursuant to the terms of the above-quoted resolution there was entered on the petitioner’s books as of December 31, 1920, the following accruals:

Charge Moe Naitove 10%	\$10,441.42
Nat Naitove 10%	10,441.42
Jack Naitove 10%	10,441.42
George Naitove, 5%	5,220.71
Moe Turman, 5%	5,220.71
Credit surplus account	\$41,765.68

“This entry gave effect to the participation by the five employees in the petitioner’s losses for the year 1920.

“Upon audit of the petitioner’s return for the year 1919, the Commissioner disallowed as a deduction from gross income the amount of \$116,548.44 accrued as additional compensation to employees for that year.

MAJORITY OPINION

“LOVE: The first question presented for our consideration is whether the amount of \$116,548.88 accrued on the petitioner's books on December 31, 1919, as additional compensation under the above-quoted resolution, constitutes an allowable deduction from gross income for the year 1919.

“The petitioner urges that to deny the deduction claimed and accrued on its books at the close of the year 1919, would not only be a reversal of the decision of the Board in the *Appeal of Block & Kohner Mercantile Co.*, 4 B. T. A. 673, but would be equivalent to holding that contingencies which may arise would abrogate a closed transaction.

“We are of the opinion that the facts in the instant appeal do not bring it within the purview of the Board's decision in the *Appeal of Block & Kohner Mercantile Co.*, *supra*. In that appeal the petitioner entered into an agreement with one Weinbach, whereby, in consideration of the mutual covenants therein, Weinbach was to work for the petitioner on a regular monthly salary and in addition thereto he was to receive one-third of the net profits earned by the petitioner and he was also to share any of the petitioner's losses. The contract was for three years unless terminated by consent or notice as provided therein, or by Weinbach's death, at which time the right to share in the net profits terminated. In holding that the amount accrued to Weinbach as of December 31, 1919, constituted a liability against the petitioner in the accrued amount, subject only

to be defeated by subsequent losses, the Board stated:

“ ‘The petitioner is entitled to this deduction on the ground that the one-third share of its profits was at the end of the year definitely committed to Weinbach, subject only to be defeated by a subsequent net loss, over which the petitioner had no control. * * *

“ ‘Weinbach had no right to have part of the profits impounded or intrusted. He merely had a cause of action in contract the damages of which would be measured by the percentage of profits. This is an accrual deduction.

“ ‘It is said that the liability is not determined until the end of the contract period, which, so far as payment is concerned, is true. Weinbach could not have sued to recover. But this is too rigid a test. As a reasonably prudent person the petitioner was committed not to impair the percentage. It was only by a business loss which the petitioner would not reasonably be supposed to bring about voluntarily that the amount could be impaired and since a subsequent loss would not be taxable, the petitioner here would be in no better tax position in any event.’

“ ‘The Board’s decision is predicated on the fact that the liability for the one-third share of its profits to Weinbach had definitely accrued as of December 31, 1919.

“ ‘Examining the agreement between the petitioner herein and the employees, as embodied in the above-quoted resolution, it

will be noted that it contains a provision to the effect that the employees shall share in the losses of the business. This provision is the only one in common with the contract between Weinbach and the petitioner as set out in the *Appeal of Block & Kohner Mercantile Co., supra*. However, in addition to this provision, the above-quoted resolution provides that the employees are not entitled to withdraw, except as provided therein, any of the *contingent* compensation unless they shall remain with the petitioner for five years, and it is further provided that in the event of the discharge or withdrawal of any employee, all right, title and interest in any of the contingent additional compensation shall revert to the petitioner.

“By reason of the language employed in the resolution and from the conditions contained therein, the petitioner incurred no liability to the employees on December 31, 1919, by accruing on its books the contingent additional compensation pursuant to the resolution. There was no absolute liability on the part of the petitioner for any part of the contingent compensation until after the expiration of five years. The accrual on December 31, 1919, was merely a memorandum entry for the purpose of ultimately determining the liability, if any. The condition in the resolution to the effect that no employee shall at any time be entitled to withdraw any sums credited to him under the terms of the resolution unless he shall remain for five years in the employ of the petitioner, is clearly a condition precedent to the accrual of any liability.

“A condition precedent is defined in *Corpus Juris*, Volume 13, page 564, as follows:

“ ‘Conditions Precedent.—A condition precedent in the law of contracts either may be a condition which must be performed before the agreement of the parties shall become a binding contract, or it may be a condition which must be fulfilled before the duty to perform an existing contract arises, and in this case may consist in performance of his promise by one of the parties or the happening of some other stipulated contingency. The question of whether stipulations in a contract constitute conditions precedent is one of construction dependent on the intent of the parties to be gathered from the words they have employed and, in case of ambiguity, after resort to the other permissible aids to interpretation.
* * *

“Looking again to the above-quoted resolution, we note that the additional compensation which the petitioner seeks to deduct was termed ‘contingent compensation.’ Upon what was it contingent? The answer is obvious. Each of the employees named in the resolution must remain in the employ of the petitioner for five years. But, any one or all of them might be discharged, or might resign or might die within the period of five years. In such case, liability on the part of the petitioner did not and would not accrue. The resolution expressed a contract in form but it was not to become operative as a contract until the *happening of the contingency*.

“In further support of its contention that it is entitled to the deduction of \$116,548.88 from gross income for the year 1919, on account of the additional compensation accrued on its books as of December 31, 1919, the petitioner cites the case of *American National Company, Receiver of the B. F. Collins Investment Company, v. U. S.*, decided by the Supreme Court, April 11, 1927, and urges that the decision therein concludes the issue in this appeal. We are of the opinion, however, that the cases are distinguishable.

“In the case cited by the petitioner, the Supreme Court stated the facts to be as follows:

“ ‘The findings of fact show that the company, an Oklahoma corporation, had been engaged since 1908 in the business of making loans secured by mortgages upon real estate, which it negotiated and sold to investors. Under its usual course of business, the borrower, upon the making of a loan, executed to the order of the company his note for the amount loaned, due in five years, with interest at five per cent per annum, payable semi-annually with the privilege of paying \$100 or any multiple thereof on the principal, on or after two years, at the maturity of any interest payment. At the same time the borrower, executed to the company another note, due in two years without interest, for ten per cent of the total amount of the loan, as the company’s commission or compensation for making and negotiating the loan. From these

commission notes the company derived its income.

“ ‘At first the company negotiated and sold the loan notes to investors entirely through brokers or agents to whom it paid fees or commissions. But from and after 1916, it sold many of those notes direct to investors; and being thus relieved from payment of those fees or commissions, and as an inducement to investors to purchase from it direct, agreed to pay them bonuses upon the notes as added consideration for the purchase, this being evidenced by a contract styled a ‘guarantee,’ which the company gave the investor, agreeing to pay him during the life of the loan, according to the terms of the note, one per cent per annum of its amount, in addition to the five per cent per annum that the borrower was to pay.

“ ‘The company consistently kept its books of account from year to year on the accrual basis. Under the practice followed from the inception of its bonus method of doing business, whenever a loan note was sold it charged on its books, as an expense incurred in the sale, the aggregate amount of the payments called for in the bonus contract, computed at one per cent per annum to the maturity of the note, and credited the investor on its books with a like amount in a subsidiary bills payable ledger. The total amount of this liability on the bonus contracts was carried on its general ledger under a control account called the Guarantee Fund Account.

“ ‘In the year 1917, in accordance with this practice, the company accrued and set up on its books as a liability and charged to expense, the aggregate amount of the payments called for in the bonus contracts given investors during that year, and it made its tax return for that year upon the basis upon which the accounts were kept, claiming as an expense the aggregate amount of these bonus contracts, as set up on its books. And as admitted in argument, although not shown specifically by the findings of fact, it also entered on its books and returned as income received during the year, the aggregate amount of the commission notes given by borrowers when it made the loans.

“ ‘Furthermore, under the company’s practice, if any loan note was paid by the borrower before maturity, the difference between the amount of the bonus contract credited to the investor’s account and the payments that had been made on the contract, was credited back to profit and loss, and treated as income of the company for the year in which the note was paid.

“ ‘The Commissioner of Internal Revenue disallowed the claim of the company for the deduction of the total amount of the bonus contracts issued in 1917, and allowed the deduction only to the extent of the installments called for by such contracts which matured in 1917, and in accordance with this ruling made the additional assessment which is here involved.’

“In holding that the company was entitled to the deduction of the aggregate amount of the bonus contracts issued in 1917, the Supreme Court, in part, stated:

“ ‘So, in the present case, we think that the amount of the bonus contracts was an expense incurred and properly attributable to the company’s process of earning income during the year 1917. These contracts were not analogous to obligations to pay interest on money borrowed, but were expenses incurred in selling the loan notes in as real a sense as if under its original system of doing business the company had paid these amounts to brokers as fees for selling the loans or given the notes for such fees. The company’s net income for the year could not have been rightly determined without deducting from the gross income, represented by the commission notes, the obligations which it incurred under the bonus contracts, and would not have been accurately shown by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected the true income. And just as the aggregate amount of the commission notes was properly included in its gross income for the year, although not due and payable until the expiration of two years, so, under the doctrine of the Anderson case, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not “accrue” in that year

in the sense of becoming then due and payable.'

"It becomes apparent, therefore, from an examination of the above statement, that the Supreme Court considered the liability on account of the bonus contracts to have become fixed in 1917. To be sure, liability for further payment on account of a bonus note might be defeated by the payment of the loan note at the expiration of two years as provided in that note. But in all events, at the time of giving the bonus notes in 1917, there was a fixed and definite liability on the part of the company, subject to defeasance only by the subsequent action of the borrower.

"In the instant appeal, as above stated, we are of the opinion that on December 31, 1919, there was no fixed liability on the part of the petitioner to pay any amount on account of the contingent additional compensation. The liability, if any, on the part of the petitioner depended entirely upon the happening of a specified contingency, namely, that each employee must remain in the employ of the petitioner for five years. We think that during the five years provided in the resolution of February 10, 1919, there was an inchoate or potential liability on the part of the petitioner, which at the expiration of that period became a fixed and definite liability for the payment of some amount of money to those employees named in the resolution who have been during the entire period in the petitioner's employ, provided, of course, that during the same period petitioner's business had been profitable.

“We, therefore, approve the action of the respondent in disallowing the deduction of \$116,548.88 from gross income for the year 1919 on account of additional compensation accrued on petitioner’s books as of December 31, 1919.

“The petitioner alleges that the respondent erred in failing to compute its profits tax for 1919 under the provisions of Section 328 of the Revenue Act of 1918. It has not, however, presented any evidence showing abnormality of income or invested capital or that any other conditions prescribed in section 327 existed. The action of the respondent in regard thereto is approved. *Appeal of Edward Rose Company*, 2 B. T. A. 341.

“Reviewed by the Board.

“*Judgment will be entered for the respondent.*

“Sternhagen, Milliken, Van Fossan and Murdock dissent.

DISSENTING OPINION

“Phillips, dissenting: I am of the opinion that the deduction claimed is allowable under the decisions of the Supreme Court in *United States v. Anderson*, 269 U. S. 422, and *American National Co. v. United States*, 6 Am. Fed. Tax Rep. 6747; 47 S. Ct. 520. I am further impelled to this conclusion by my opinion that if the amount claimed (which is admittedly an ordinary and necessary expense of the business and deductible in some year as such) is ever to

be allowed, it must be as an expense of conducting the business for the year in question.

“It seems that at the end of the year the employees had done everything required of them to earn the compensation in question. Subject to certain contingencies under which these employees might lose the right to demand payment, the petitioner was obligated to the employees for the amount in question. The contingencies affected the payment, not the accrual of the liability; as to payment, these contingencies may be conditions precedent, but in my opinion the liability accrued in the taxable year subject only to certain conditions subsequent under which it might be wiped out.

“I appreciate that difficulties are involved in the acceptance of this view in determining the course to be followed in computing income for subsequent years should this liability be cancelled in such subsequent years by losses of the business or termination of the employment. The agreement of the employees that this compensation should be subject to diminution by subsequent losses may properly be treated as a sharing of such losses of the petitioner by the employees, and to the extent that such losses are borne by the employees, the petitioner is compensated and to that extent does not sustain the full loss of such subsequent year.

“The effect upon income of a discharge or withdrawal of the employees within five years is not so clear. Whether income would be realized from an act by which the amount theretofore earned by the em-

ployee was to 'revert to this corporation' (to use the words of the resolution) is not before us. It appears, however, that in *American National Co. v. United States, supra*, the court allowed a deduction for the full amount contracted to be paid over a period of years, although it appeared that such amount might be reduced prior to the date of payment. In that case the taxpayer had treated the amount of his reduced liability as income in the year of such reduction. While the court does not comment on this situation, it does state that the method which was adopted clearly reflected the true income, thereby implying that a change in the liability must, by reason of the method of accounting followed by the taxpayer, be accounted for as income.

"In the case before us it will scarcely be contended that the financial condition of the petitioner could have been reflected without showing the liability to its employees and in my opinion its true net income for the year could not be computed without allowing the deduction claimed. For these reasons I dissent from the conclusion reached.

"Morris concurs in the dissenting opinion."

Thereafter, on October 10, 1927, the Board entered its final order and decision in accordance with the majority opinion, approving the deficiency determined by the appellee in the amount of \$59,049.33 as aforesaid (R. 30). From this decision the petitioner appealed (R. 32).

ASSIGNMENT OF ERRORS

This appellant, for its assignment of errors, says the Board in issuing said majority opinion and in entering said order and decision erred, as follows:

1. The U. S. Board of Tax Appeals erred in holding that the amount of \$116,548.44 was not a proper deduction from gross income in computing its taxable net income for the calendar year 1919.

2. The U. S. Board of Tax Appeals erred in holding that the compensation for employees accrued on the books of the petitioner in the amount of \$116,548.44 was not an ordinary and necessary expense of the business and deductible from gross income in the calendar year 1919 when this expense was incurred to produce the income of that year.

3. The decision and order of final redetermination of the U. S. Board of Tax Appeals is not supported by the facts as found by said Board.

4. The U. S. Board of Tax Appeals erred in entering its order and judgment approving the deficiency in tax for the calendar year 1919 in the amount of \$59,049.33 as found by the respondent in the disallowance of the said accrued compensation of \$116,548.44.

Argument

1. A statement of the question involved.

The question upon which the members of the Board of Tax Appeals divided in this case, and the question presented to this Court for review, is purely a question of the construction of the statute. The minority members of the Board accepted without dispute the findings of fact made by the majority of the Board, and the appellant corporation raises no question as to such findings.

The findings of fact made by the Board, upon which this Court must determine the question here under consideration, establish that the appellant corporation had five employees who held important positions and who constituted the entire staff of the business for the purpose of buying and selling. These employees were dissatisfied with the compensation being paid to them by the appellant and they informed the appellant's president that they were contemplating going into business for themselves. In order that those employees would remain with the appellant an agreement was entered into, by which agreement they would participate in the profits of the business. This agreement was expressed in a resolution passed by the Board of Directors of the petitioner on February 10, 1919, which provided that the five employees would receive as additional compensation for the year 1919 certain percentages of the net profits of the business for that year amounting, in the aggregate, to 40 per cent of the net profits of the business. The agreement provided,

however, that such sums as the employees became entitled to under the terms of this resolution "shall remain in the business at the risk of the business for a period of five years, and that prior to the expiration of said period said officers and employees shall be entitled to demand and receive payments of the sums to which they may become entitled only to the extent that drawings against such sum may be authorized by the president of the company." It was further provided that such sum, during the five-year period, should "be at the risk of the business in the sense that it shall be subject to pro rata deductions in the event that losses are incurred by the business during the period within which such sums are to remain at the risk of the business," and that such employees should remain in the employ of the company for a period of five years.

The findings of fact also establish that the appellant corporation kept its books of account on the so-called accrual basis of accounting, and, pursuant to the resolution above mentioned, accrued on its books as of December 31, 1919, a correctly computed entry which charged as an expense to selling and commissions the amount of \$116,548.44 and credited to each of the five employees the respective amounts due them aggregating this sum.

The Board further expressly found what would seem to negative the possibility that the compensation to employees here in question should be treated as other than a proper deduction:

"The compensation provided for in the

above-quoted resolution and which was accrued on petitioner's books, was reasonable for the services rendered by those employees in the year 1919."

In spite of these clear findings of fact, when it came to the question of the deductibility of this amount as a 1919 business expense, in determining the taxable income of the appellant corporation for the year 1919, the Board below was widely divided. Four members dissented without opinion. A fifth wrote a dissenting opinion in which a sixth member concurred.

The majority opinion of the Board, although starting with the premise that the compensation in question was reasonable compensation for services actually rendered by employees in the year 1919, and that such compensation was actually accrued on the books of the appellant corporation for the year 1919, nevertheless holds that the *technical liability* therefor did not accrue in 1919 and that the amount was not deductible in that year. Mr. Love, writing the majority opinion, states:

"There was no absolute liability on the part of the petitioner for any part of the contingent compensation until after the expiration of five years."

It should be noted that the majority do not question that this item of reasonable compensation for services is, in its inherent nature, an allowable deduction from gross income. That is conceded. The question the majority opinion apparently raises is whether the deduction was prop-

erly taken in the year 1919, when the appellant corporation actually accrued it on its books, or in some later year.

It appears, however, that if the deduction cannot be taken as an expense for 1919, when the services were actually rendered and the compensation actually accrued on the books of the corporation, it cannot be taken in any later year. Mr. Phillips states, in the dissenting opinion:

“I am further impelled to this conclusion by my opinion that if the amount claimed (which is admittedly an ordinary and necessary expense of the business and deductible in some year as such) is ever to be allowed, it must be as an expense of conducting the business for the year in question.”

This statement of the dissenting opinion finds ample support in the decisions of the Board.

Thus in *Appeal of Wall & Ochs, Inc.*, Docket No. 3857, 4 B. T. A. 1093, it was held that, although the Commissioner had disallowed salaries accrued to officers in 1917, on the theory that they were paid in 1918, the corporation could not deduct them as an expense in 1918.

So, also, in *Appeal of Theodore A. Kohn & Son*, Docket No. 5364, 3 B. T. A. 1075, the Board held that a taxpayer, on the accrual basis, could not deduct in 1920 salaries paid in that year, but for services rendered in prior years.

So, also, in *McCabe Lathe & Machinery Co. v.*

Commissioner, Docket No. 3072, 9 B. T. A. 1137, the Board held that a taxpayer, on an accrual basis, could not deduct in 1919 a payment made to an employee in that year, representing additional compensation for services rendered in 1918 and based on profits for that year, even though the taxpayer disputed the claim when asserted in 1918 and paid it in 1919 only after a suit was brought by the employee.

See also *McDonald Lumber Co. v. Commissioner*, Docket No. 5153, 5 B. T. A. 731 and *Appeal of Green Oil Soap Co.*, Docket No. 3574, 3 B. T. A. 467.

2. Erroneous basis upon which the opinion of the majority of the Board proceeded.

The majority opinion of the Board states, that by reason of the language employed in the resolution providing for the compensation and the conditions contained therein, the petitioner incurred no liability to its employees therefor, as of December 31, 1919. This ruling was based primarily on the reasoning that the condition contained in the resolution that "no employee shall at any time be entitled to withdraw any sums credited to him under the terms of the resolution unless he shall remain for five years in the employ of the petitioner is clearly a condition precedent to the accrual of any liability." (This statement that no employee "shall at any time" be entitled to withdraw any of such sums is not supported by the facts as found by the Board. The resolution set forth in its finding specifically provided that withdrawal of such sums could be made "to the ex-

tent that drawings against such sums may be authorized by the president of the company.”)

The Board as its authority for the above holding, quoted the definition of “conditions precedent” contained in *Corpus Juris*, Volume 13, page 564, as follows:

“Conditions precedent.—A condition precedent in the law of contracts either may be a condition which must be performed before the agreement of the parties shall become a binding contract, or it may be a condition which must be fulfilled before the duty to perform an existing contract arises, and in this case may consist in performance of his promise by one of the parties or the happening of some other stipulated contingency. The question of whether stipulations in a contract constitute conditions precedent is one of construction dependent on the intent of the parties to be gathered from the words they have employed and, in case of ambiguity, after resort to the other permissible aids to interpretation. * * *”

Concerning this, the majority opinion says:

“Looking again to the above-quoted resolution, we note that the additional compensation which the petitioner seeks to deduct was termed ‘contingent compensation.’ Upon what was it contingent? The answer is obvious. Each of the employees named in the resolution must remain in the employ of the petitioner for five years.”

Here, again, we feel that the majority of the

Board has erred. It is true that in the resolution itself the petitioner *called* the compensation "contingent compensation," but the contingency referred to was not that assumed in the majority opinion: viz., that the employees should remain in the employ of the company for five years. A careful analysis of the resolution indicates that the *contingency* referred to in the phrase quoted above was the making of profits in the year 1919 by the corporation. If the corporation made no profits in 1919, the employees would not have been entitled to a penny for compensation, no matter how long they remained in its employ. Length of employment was not the contingency which gave them the *right* to such compensation, or, conversely stated, this was not the contingency which *brought into existence* the *liability* of the appellant *for such compensation*. The contingency which determined the right and brought into existence the liability *was the making of profits by the corporation during the year, of which 40 per cent of the total, as and when made, became the property of the employees.*

As stated in the definition, quoted with the approval of the Board: "The question of whether stipulations in a contract constitute conditions precedent is one of construction dependent on the intent of the parties to be gathered from the words they have employed * * *." The majority opinion looks at the *one* phrase "contingent compensation," and rather hastily assumes that the contingency referred to is not one which is concluded during the year 1919, but continues as a contingency for the five-year period. The majority opinion then bases its entire conclusion

upon that erroneous construction of an isolated term. It totally ignores the balance of the contract. Thus, even in the sentence which contains the conditions referred to, it is stated:

“Provided, however, that any and all sums to which the above-named officers and employees *may become entitled* under the terms of this resolution shall remain in the business at the risk of the business for a period of five years.” (Italics ours.)

There could be no more definite admission of a liability. The resolution itself definitely states that the employees “become entitled” to the compensation when the profits are made, that is within the year 1919. In fact, when we read closely the sentence of the resolution which contains the conditions, we find that it contains the words “may become entitled” or “shall be entitled” four separate times in speaking of the compensation as accruing to the employees during the business year 1919.

The resolution further states that “in the event of the discharge of any such officer or employee or withdrawal during such period, all right, title or interest of such officer or employee in or to any sums credited to said officer or employee under the terms of this resolution shall *revert* to this corporation.” The words “right, title and interest of such officer or employee” are significant. If, as the Board holds, the completion of five years’ service was a condition precedent the employees would never acquire any “right, title or interest” until the end of the five-year period. The contract clearly intends that they should ac-

quire a "right, title or interest" to their share of the profits when those profits were made (in the year 1919), and it follows that the employees could only acquire a "right, title or interest," by the employer assuming a liability in the amount thereof.

The use of the word "revert" is also significant. It obviously contemplates that the right, title and interest to the compensation should vest in the employees at the end of the year 1919, but if the condition mentioned *subsequently* occurred, such right, title and interest would "*revert*" to the corporation.

We believe that the fundamental question before the Board was not whether the provisions in the contract under which the compensation was credited were technically "conditions precedent" or "conditions subsequent," but whether, in fact, such compensation was properly accrued by the corporation on its books as an expense of 1919, so as to correctly reflect taxable income for that year. To the extent that it be deemed important, we maintain, however, that the condition contained in the resolution that such compensation should remain in the business at the risk of the business was not a condition precedent which would prevent the title to the compensation passing to the employees, as was held by the majority opinion of the Board, but was a condition subsequent, which, upon its happening, might defeat the right or estate already created and vested. Thus, quoting the same authority from which the Board derives its definition, *Corpus Juris*, at Volume 12, page 410, we find that a condition subsequent is "a

condition which operates upon an estate already created and vested, and renders it liable to be defeated * * *."

Considering the entire resolution which comprises the contract, it is evident that it was the intent of the parties that the liability should become established, that the right, title and interest to the compensation should become vested as and when the profits for the year were made and the amounts credited to the employees. Mere payment of the amounts, however, was to be withheld so that the interest acquired by the employees should remain in the business at the risk of the business for five years. If the conditions named therein subsequently occurred, during that period, the right to such compensation should be defeated and the right thereto should "revert to the corporation."

We contend that the dissenting opinion of Mr. Phillips, in the Board below, which was concurred in by Mr. Morris and which had the implied support of four other members of the Board who also dissented, more correctly states the applicable rule of law, as follows:

"It seems that at the end of the year the employees had done everything required of them to earn the compensation in question. Subject to certain contingencies under which these employees might lose the right to demand payment, the petitioner was obligated to the employees for the amount in question. The contingencies affected the payment, not the accrual of the liability; as to payment, these contingencies may be

conditions precedent, but in my opinion the liability accrued in the taxable year subject only to certain conditions subsequent under which it might be wiped out.”

3. Majority opinion of the Board here inconsistent with other decisions of the Board.

We confess to some difficulty in following the distinction which the majority opinion of the Board in this case makes as to its prior decision in *Appeal of Block & Kohner Mercantile Company*, 4 B. T. A. 673.

In the *Block & Kohner* case, an employee was given one-third of the net profits earned by the taxpayer and was to share the losses. The contract was for a three-year period unless sooner terminated, as therein provided, or by the death of the employee. The Board held that the amount accrued as the employee's share of profits at the end of the first year, although subject to be defeated by subsequent losses, constituted a proper accrual deduction for the taxpayer. The majority opinion in this case quotes language from the opinion in the *Block & Kohner* case, which states clearly that the employee could not have sued at the end of the first year for the share of profits which was accrued to him, because there were conditions precedent to *payment*, but discards that as a test and allows the accrual. By way of distinguishing the instant case from the *Block & Kohner* case, the majority opinion points out that here there were other conditions which might defeat payment, namely, the withdrawal or discharge of the employee.

If the existence of a so-called "condition precedent" to payment renders an accrued item of expense an improper deduction, how can it be decisive in principle whether there is one condition which may defeat or reduce the ultimate payment, or two?

The taxpayer urged upon the Board at the trial of this case its decision in the *Appeal of Block & Kohner Mercantile Company* as a binding precedent. While that decision does not have force as a precedent in this forum, we urge upon this Court a consideration of the opinion of the Board of Tax Appeals in the *Block & Kohner* case as a sound exposition of the law as to accrual, conforming to the decisions of the Supreme Court of the United States hereinafter discussed.

As to the condition in the arrangement here in question that the employees could not withdraw any part of their accrued compensation for 1919 until the end of the five-year period except with the approval of the president of the corporation, the Board of Tax Appeals held in *Oliver H. Van Horn Co., Inc. v. Commissioner*, 9 B. T. A. 76, where a corporation agreed to pay to its employees certain salaries upon the condition that no substantial part of such salaries could be withdrawn without the consent of the Board of Directors, and that undrawn salary was to draw interest at the rate of eight per cent, that the corporation taxpayer was entitled to treat both undrawn salaries and interest as proper deductions in the year when the services were rendered even though they were not withdrawn until later years.

So, in *Perkins Land and Lumber Co. v. Com-*

missioner, 9 B. T. A. 528, decided December 9, 1927, the Board held that salaries "payable only at such time as the company shall have on hand cash sufficient to retire all its current liabilities" were properly accruable on the books of the company and properly deductible in the year the services were rendered even though payment was not to be made until a later year.

4. **The statutes and the regulations promulgated by the Commissioner thereunder determine that the year when deduction may be taken shall be controlled by the method of accounting employed by the taxpayer.**

Section 234(a) (1) of the Revenue Act of 1918 provides that all corporations may deduct from the gross income reported:

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, * * *."

The words "paid or incurred" as used in this section are defined in Section 200 of the same Act, as follows:

"The term 'paid' for the purposes of the deductions and credits under this title, means 'paid or accrued' or 'paid or incurred,' and the terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212."

Section 212(b) provides that:

“The net income shall be computed upon the basis of the taxpayer’s annual accounting period (fiscal year or calendar year, as the case may be) *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer*; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.” (Italics ours.)

The Board made no finding that the method of accrual accounting used by the appellant corporation did not clearly reflect its income, and the facts specifically found by the Board show that the accrual of the item here in question, for the year 1919, was essential to clearly reflect income for that year. The Board found, for instance, that the compensation actually accrued by the appellant corporation on its books during the year 1919, “was reasonable for the services rendered by those employees in the year 1919.” This fully meets the test as to the year in which an item of expense should be accrued, under an accrual system of accounting, as laid down by the Commissioner of Internal Revenue.

Article 111 of Regulations 45, promulgated by the Commissioner of Internal Revenue under authority of the Revenue Act of 1918, states:

“* * * A person making returns on an accrual basis has the right to deduct *all*

authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities." (Italics ours.)

Even prior to the promulgation of Regulations 45, the Commissioner had issued Article 126 of Regulations 33, under the Revenue Act of 1916, which stated the proper test as to the deductibility of expenses under the accrual method, to be as follows:

"If the amount involved represents an actual expense or *element of cost in the production of the income of the year*, it will be properly deductible even though not actually disbursed in cash, provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis." (Italics ours.)

A concise definition of the accrual basis of reporting income is contained in the decision of the Board in the *Appeal of American Express Company*, 2 B. T. A. 498, 504, as follows:

"* * * the theory and the purpose of actual accounting is to apportion to each accounting period such parts of continuing expenses as are *properly chargeable against the business of each respective period*." (Italics ours.)

In its opinion in *Estate of Bull v. Commissioner*, 7. B. T. A. 993, decided August 8, 1927, the Board of Tax Appeals makes the following statement as to accrual accounting under the Revenue Act of 1918:

“In the Revenue Act of 1918 Congress sanctioned the determination of net income in accordance with the taxpayer’s regular method of accounting, subject however to the necessary safeguard that the method should clearly reflect income.”

The Solicitor of Internal Revenue, in his published Memorandum No. 4499a, Internal Revenue Bulletin V-17-2722, interprets the decision of the Supreme Court in *United States v. Anderson*, 269 U. S. 422, as laying down, *inter alia*, the following principles:

“The income earned during any taxable year by a taxpayer keeping its books of account on the accrual basis must be charged with all the expenses incurred in, and attributable to, the process of earning such income; true annual income is only determinable after making due allowance for the *total* cost and expenses attributable to the production of that income; * * *

The question presented in the present case is the determination of the proper year in which a deduction for compensation to employees may be taken. This question must be decided in conformity with the statutory provisions above quoted. To do so it is only necessary to determine the basis of accounting employed by the appellant in

keeping its books and in reporting its income for taxation. This is settled by the undisputed findings of fact made by the Board below, which expressly find that the appellant kept its books and returned its income on the accrual basis, and, further, that as of December 31, 1919, the appellant entered the amount of such compensation upon its books as a liability owing to the employees affected thereby (R. 17).

5. The disallowance of actual expenses of business necessary to the production of income, by a strained application of technical rules of law, is not within the intent of the Revenue Acts.

It cannot be too often emphasized that the majority of the Board, although they seek to reject the accrued compensation item as an expense of 1919, expressly found:

“The compensation provided for in the above-quoted resolution and which was accrued on petitioner’s books, was reasonable for the services rendered by those employees in the year 1919.”

Throughout the income tax laws there occur ample evidences that Congress intended the determination of taxable income to be a *practical operation*, in which *real* items of expense involved in the production of gross income should be deducted from gross income to arrive at taxable income, rather than a matter of the involved application of technical rules of law. It was not intended that the taxpayer, whether the proprietor

of a country store or a great industrial concern, should retain a legal staff to sit at the book-keeper's shoulder to guide him in the accrual upon the books of business transactions. The law and the regulations contemplate a broader policy,—one which would allow for the differences which cannot be avoided in the application of a law which reaches, annually, every business concern in the nation.

No greater need for such breadth of provision exists than in the consideration of the accrual of items of expense and income, and this spirit has been shown by the Board and the Courts. Thus, in *United States v. Anderson*, 269 U. S. 422, the Supreme Court was called upon to determine the year in which certain munitions taxes might be deducted from gross income. In that case, the taxes in question were levied on munitions manufactured and sold in 1916 but were not due or paid until during the year 1917. The taxpayer kept his books on the accrual basis. The taxpayer desired to claim the deduction in 1917, when higher tax rates prevailed and contended that under recognized rules of law a tax does not "accrue" until it becomes "due and payable." The Government contended that the taxes accrued in the year 1916.

In rejecting the contention of the taxpayer, the Supreme Court stated, at page 440:

"Only a word need be said with reference to the contention that the taxes upon munitions manufactured and sold in 1916 did not accrue until 1917. In a *technical legal sense* it may be argued that a tax does

not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. *In the economic and business sense with which the statute and Treasury decision were concerned, the taxes had accrued.*" (Italics ours.)

The Board, likewise, has recognized this policy in its decisions. Thus, in the *Appeal of Amalgamated Sugar Company*, 4 B. T. A. 568, the Board was called upon to determine when certain sales of sugar had "accrued" as income. The sugar was sold by contract in one year and delivered in the next. The taxpayer kept accounts upon a basis under which the sales were accrued as income in the year when the contract was signed. The Commissioner contended that legal title did not pass until the following year when the goods were segregated and delivered, and, therefore, that no income arose until that year. Argument was made at length as to whether the fungible goods doctrine of law applied to such sales so as to pass title. The majority opinion of the Board stated, at page 580:

"The uniform and unquestioned practice of the taxpayer was to regard these contracts as reflecting income. Its customers

so regarded them. Its balance sheets treated the price among its assets. This is a consistent basis for accrual and we think it may not be denied on the questionable if not definitely incorrect ground that title remained in the seller."

In the concurring opinion, in which it was definitely held that legal title did *not* pass in the year claimed, it was stated, at page 584:

"I am satisfied, however, that the taxpayer has established an accounting practice which was consistent and reflected its income. Where such is the case, legal theories should not be applied to a point where, in such a case as we have here, it becomes necessary for the taxpayer to determine at his peril when legal title passes under each contract into which he may have entered. *The refinements of the law must sometimes give way to practical considerations, and this I conceive to be the intent of Section 212 (b) of the Act.*" (Italics ours.)

In the present case we find the Board basing its majority opinion upon a very delicate distinction between what are known, in the law, as conditions precedent and conditions subsequent. No nicer refinement of law can be found. As stated in Anson on Contracts (Footnote, page 413, American Edition):

"* * * the confusion between conditions precedent and conditions subsequent is both ancient and respectable, in property law as well as in contract law, * * * ."

That the conditions contained in the contract in this case are not conditions precedent which prevent the contract from becoming operative and the liability from coming into existence, but are conditions subsequent which can have only the effect of defeating the vested right or extinguishing the created liability, is pointed out above. However, even though this were not the case, we submit that the accrual of income and deductions in what the Supreme Court terms "the economic and business sense with which the statute and Treasury decision were concerned" should not be determined by such nice refinements of the rules of substantive law.

Here the taxpayer entered into a contract under which it became liable to pay its employees, as admittedly reasonable compensation for services rendered in the year 1919, 40% of the profits made in that year. It recognized the liability at the end of the year and, by accruing the same on its books, adopted a method of accounting in connection therewith which reflected its income. In the following year it adhered to this method in accounting for losses under a similar contract for the following year. It, perhaps, never heard of conditions precedent and conditions subsequent but it was keeping its books so as to correctly reflect its income, and such a method we submit is within the concept of Section 212 (b) of the Act.

6. The fundamental test to determine whether a method of accounting is acceptable under the Revenue Act is to determine whether that method correctly reflects income.

The majority opinion of the Board fails anywhere to consider as a controlling factor the method of accounting employed by the appellant, nor does it consider whether or not the income of the appellant can be correctly reflected without the deduction of the compensation in question. It bases its entire theory upon the reasoning that no legal liability became fixed. Thus it states:

“In the instant appeal, as above stated, we are of the opinion that on December 31, 1919, there was no fixed liability on the part of the petitioner *to pay* any amount on account of the contingent additional compensation.” (Italics ours.)

As heretofore pointed out, Section 212 (b) of the Revenue Act of 1918 (which entirely controls the time when a deduction must be taken) says nothing whatever about the accrual of technical legal liabilities. It merely provides that:

“The net income shall be computed * * * *in accordance with the method of accounting regularly employed in keeping the books of such taxpayer*; but if no such method of accounting has been so employed, or if the method employed does not *clearly reflect the income*, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does *clearly reflect income*.” (Italics ours.)

Under these provisions we submit that the Commissioner of Internal Revenue has no authority to disturb the method of accounting adopted by the taxpayer unless that method does not clearly reflect income. Therefore, the sole test, which is not even mentioned in the majority opinion, is whether the method actually adopted by this taxpayer does reflect its true income. This fundamental test was applied, however, by the dissenting members of the Board. Their opinion concluded with the following statement:

“In the case before us it will scarcely be contended that the financial condition of the petitioner could have been reflected without showing the liability to its employees, and in my opinion its true net income for the year could not be computed without allowing the deduction claimed.”

Ample support for this conclusion of the dissenting opinion may be derived from the findings of fact of the majority, and especially their finding that:

“The compensation provided for in the above-quoted resolution and which was accrued on petitioner's books, was reasonable for the services rendered by those employees in the year 1919.”

We further believe that a consideration of the full facts in the case completely justifies this conclusion. Here were the five most valuable employees of the appellant corporation who were dissatisfied with the compensation being paid to them and were contemplating going into business

for themselves (R. 16). In order to hold their services the corporation entered into an agreement with them by which it agreed to give them, in the aggregate, 40 per cent of the net profits for the year 1919. It is at once evident that the profits for the year 1919 could not possibly be correctly reflected without deducting therefrom that portion of the same profits which it was agreed should go to the employees. In reality the compensation is a commission paid to such employees out of the profits for that year, *in consideration of their services in earning those profits*. The majority opinion of the Board denies the deduction because of the possibility of such commissions reverting in part to the corporation, but it ignores the fact that in order to consider 100 per cent of the profit as belonging to the corporation at all it *must* be assumed that all of the employees *will be discharged* during the five year period. In effect, the Board denies the deduction because of the possibility that some of the employees *may* leave the service and then includes their profits in the income of the corporation on the uncertain assumption that *all* of them *will be discharged*.

We may also consider the compensation from the viewpoint of the financial condition of the company at the close of 1919. Suppose on December 31, 1919, the appellant had desired to borrow money from its bank and had been requested by the bank to furnish it with a statement showing all of its assets and liabilities. The Commissioner, in denying the accounting method adopted by the appellant, supports the view that it would have been entirely proper for the appellant to render

such a statement of assets and liabilities without mentioning at all its liability to these employees in the amount of \$116,548.44. We submit that if such a statement had been rendered without mention of this liability it would not have clearly reflected the financial condition of the company. In fact, it might reasonably be said, under such circumstances, that the failure to accrue this liability would constitute a fraud upon the bank.

In *United States v. Anderson*, 269 U. S. 422, referred to above, the Supreme Court states the theory of the accrual method of accounting as follows (page 440):

“It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, *by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period*; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.” (Italics ours.)

Here we have the essential test of determining when a deduction should be taken under an accrual system of accounting. The Supreme Court says:

“* * * by charging against income earned during the taxable period the expenses incurred in and properly attributable to the process of earning income during that period.”

It is interesting to note that in a later case, *American National Co. v. United States*, 47 Sup. Ct. 520, the Supreme Court quoted the above opinion of the *Anderson* opinion and italicized the clause which we here use.

In this case it is manifest that the additional compensation paid to the employees was incurred in and properly attributable to the process of earning income during some taxable period. Applying this test we have only to determine the year in which the income was earned by the services of these employees in order to determine the year in which the deduction must be taken. The appellant corporation said, in effect, to its employees: "If you will make profits for me during the year 1919 I will pay you 40 per cent of those profits." Under such a contract, if this compensation was not "incurred in and properly attributable to the process of earning income" during the year 1919, we do not know to what other year it is attributable.

7. Majority opinion of the Board rests on a failure to correctly interpret the Supreme Court's decision in the *American National* case which supports appellant corporation's contention here.

The majority opinion of the Board goes at some length to distinguish the decision of the Supreme Court in the case of *American National Company, Receiver, v. United States*, 47 Sup. Ct. 520. In that case, to state the facts as simply as possible, the taxpayer was engaged in the business of mak-

ing loans secured by mortgages upon real estate. Upon making a loan the company received from the person to whom the loan was made, two notes. The first note was for the amount loaned, payable in five years with interest at 5 per cent per annum. This note was payable semi-annually, with the privilege of paying \$100 or any multiple thereof on the principal after two years at the maturity of any interest payment. The second note received was due in two years, without interest, and was in an amount equal to 10 per cent of the total amount of the loan made by the taxpayer. This second note was the company's commission or compensation for making and negotiating the loan, and it was from these commission notes that the company derived its income.

Prior to 1916 the company had sold its loan notes through brokers, to whom it paid fees or commissions, but from and after 1916 it sold many of those notes direct to investors. As an inducement to such investors to purchase loan notes from it direct, the company agreed to pay them bonuses upon the notes in the amount of 1 per cent per annum during the life of the notes sold, in addition to the 5 per cent per annum already payable on such notes by the maker. The company kept its books of account from year to year on the accrual basis. The company adopted a method of accounting as follows:

“* * * whenever a *loan* note was sold it charged on its books, as an expense incurred in the sale, the aggregate amount of the payments called for in the bonus contract, computed at 1 per cent per annum to

the maturity of the note, and credited the investor on its books with a like amount, in a subsidiary bills payable ledger. The total amount of this liability on the bonus contracts was carried on its general ledger under a control account called the Guarantee Fund Account. * * * if any loan note was paid by the borrower before maturity, the difference between the amount of the bonus contract credited to the investor's account and the payments that had been made on the contract, was credited back to Profit and Loss, and treated as income of the company for the year in which the note was paid." (Italics ours.)

In 1917, in accordance with this practice, the company accrued and set up on its books as a liability and charged to expense the aggregate amount of the payments called for in the bonus contract given investors during that year, and in making its tax returns claimed as an expense the aggregate amount of these bonus contracts as set up on its books, although the liability was only payable in part in the taxable year, the balance payable in installments over a five-year period, and might *never* be paid as to part thereof, if the payment of the loan notes were anticipated by the borrowers, as was their right.

The Supreme Court expressly noted that if any loan was paid by the borrower before maturity so that it was not necessary to pay the full amount of the bonus liability set up, the unpaid amount was credited back to profit and loss and treated as income of the company for the year in which the note was paid.

The Commissioner of Internal Revenue disallowed the claim of the American National Company for the deduction of the total amount of bonus contracts issued in 1917, and allowed the deduction only to the extent of installments called for by such contracts which matured in 1917. The Supreme Court, in its opinion, quoted at some length from its previous decision in the case of *United States v. Anderson*, 269 U. S. 422, which we have referred to above, and then stated:

“So, in the present case, we think that the amount of the bonus contracts was ‘an expense incurred and properly attributable’ to the company’s process of earning income during the year 1917. These contracts were not analogous to obligations to pay interest on money borrowed, but were expenses incurred in selling the loan notes in as real a sense as if under its original system of doing business the Company had paid these amounts to brokers as fees for selling the loans or given them notes for such fees. The Company’s net income for the year could not have been rightly determined without deducting from the gross income represented by the commission notes, the obligations which it incurred under the bonus contracts, and would not have been accurately shown by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected the true income. And, just as the aggregate amount of the commission notes was properly included in its gross income for the year—although not due and payable until the expiration of two years—so, under the doc-

trine of the *Anderson* case, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not 'accrue' in that year, in the sense of becoming then due and payable."

The majority opinion of the Board in the present case quotes the above and then adds:

"It becomes apparent, therefore, from an examination of the above statement, that the Supreme Court considered the liability on account of the bonus contracts to have become fixed in 1917."

We have puzzled over this language in an effort to find in it the basis of a distinction between the *American National* case and the instant case. One difficulty is that nowhere in its entire decision in the *American National* case, does the Supreme Court say anything about any liability becoming fixed. On the other hand, it says:

"The total amount of the bonus contracts was deductible as an expense incurred within that year, *although it did not 'accrue' in that year in the sense of becoming then due and payable.*" (Italics ours.)

The Supreme Court bases its opinion upon the fact italicized in its opinion that the expense was "incurred and properly attributable to the process of earning income during that year," and allows the deduction even though the liability to pay the amount did *not* arise in that year, *and might be defeated in part by the payment of the loan note before maturity.*

We must confess that we are at a loss to reconcile the Board's premise with its conclusion, and we submit, on the other hand, that the deduction here is allowable under a fair construction of this decision of the Supreme Court.

A simple illustration of the facts in the *American National* case would be as follows:

The American National Company would loan \$1,000 to a borrower. It would then receive two notes from the borrower, one a five year note in the amount of \$1,000.00, bearing interest at the rate of 5% per annum; and another note in the amount of \$100.00, due in two years without interest. The American National Company would then sell the \$1000 note to some investor, manifestly to obtain the additional funds to make further loans, and would guarantee to pay to such investor additional interest at the rate of 1% per annum during the life of the note. In other words, they would guarantee to pay to the investor \$10.00 a year for five years, unless the \$1,000 note was paid by the borrower before maturity, as was his right. Under the accounting method adopted, the company would then accrue as income the \$100.00 note received from the borrower, and in the same year it would accrue as an expense the entire amount which it guaranteed to pay to the investor, if the loan note remained unpaid for the full five year period, that is, \$50.00.

There was no legal liability whatever for the American National Company to pay the \$50.00 so accrued as an expense in the taxable year. Its only contract was to pay \$10.00 a year for five

years if the loan note was not paid before the expiration of that period. However, the Supreme Court held that the entire amount of \$50.00 was an expense "incurred in and attributable to the process of earning" the \$100.00 reported as income, and allowed the deduction on that ground. It so held while clearly recognizing that the liability accrued on the books might ultimately need to be met only in part owing to subsequent happenings; viz., the anticipation by the borrower of the maturity date of the loan note.

We believe this decision furnishes the controlling rule in the present case. The compensation which the appellant claims as an expense was a definite percentage of the very profits which are reported as gross income. The employees who became entitled to that compensation constituted the "entire staff of the business for the purpose of buying and selling" (R. 16). It was their *services* which *produced* the income which is reported and taxed. We again quote the undisputed finding of the Board that:

"The compensation provided for in the above-quoted resolution and which was accrued on petitioner's books, was reasonable for the services rendered by those employees in the year 1919."

We submit that the compensation for those services is an expense "incurred and properly attributable to the process of earning income during that year" and no other.

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Of Counsel.

No. 4768

**Court of Appeals of the District of
Columbia**

S. NAITOVE & COMPANY, INCORPORATED, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE

APPEAL FROM THE BOARD OF TAX APPEALS

BRIEF FOR APPELLEE

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PREVIOUS OPINION IN THE PRESENT CASE

The only previous opinion in the present case is that of the United States Board of Tax Appeals (R. 11) reported in 8 B. T. A. 589.

JURISDICTION

The appeal in the above-entitled cause involved income taxes for the year 1919, in the amount of \$59,049.33, and is taken from a decision of the Board of Tax Appeals promulgated October 10, 1927. (R. 23.) This case is brought to this court by petition for review filed March 23, 1928 (R. 24), pursuant to the provisions of the Revenue Act of 1926 (Act of February 26, 1926, c. 27, Secs. 1001, 1002, 1003, 44 Stat. 9, 109, 110).

QUESTION PRESENTED

Whether the Commissioner in the audit of appellant's return for 1919, made on the accrual basis, properly disallowed a deduction of additional compensation to certain employees, which appellant, keeping its books on the accrual basis, had entered on its books as an accrued expense, pursuant to a certain resolution of its Board of Directors.

STATUTES INVOLVED

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, 1064, 1058. provides:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity; * * *

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis

as is provided in subdivision (b) of section 212 or in section 226.

SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 200. That when used in this title—

* * * The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

STATEMENT OF FACTS

The Board found the facts to be as follows:

The petitioner is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 725 Broad-

way, in the City of New York. Its business is that of buying and selling woolen, silk, and cotton goods.

Samuel Naitove, petitioner's president, was general executive in charge of the business, and during the year 1919 he owned 85 per cent of the outstanding capital stock. The remaining 15 per cent of the outstanding capital stock was owned by Herbert H. Rabiner, a member of the Board of Directors.

Petitioner had five employees who held important positions and who constituted the entire staff of the business for the purpose of buying and selling. One of these employees did all of the buying in his department, another assisted the president of the company in buying in the department over which the president gave personal supervision, two others were efficient salesmen, and another handled all of the credit matters.

These employees were dissatisfied with the compensation being paid to them by the petitioner and they informed the petitioner's president that they were contemplating going into business for themselves. In order that those employees would remain with the petitioner an agreement was entered into between the petitioner and the employees by which agreement they would, under certain conditions, participate in the profits of the business. This agreement was expressed in a resolution passed by the Board of Directors of the petitioner on February 10, 1919, as follows:

Resolved, That additional compensation for the year 1919 be paid to the following officers and employees of the company in accordance with the practice of the company on the following basis:

Mr. Moe Naitove, 10% of the net profits for the year 1919.

Mr. Nat Naitove, 10% of the net profits for the year 1919.

Mr. Jack Naitove, 10% of the net profits for the year 1919.

Mr. Moe Turnan, 5% of the net profits for the year 1919.

Mr. George Naitove, 5% of the net profits for the year 1919.

Provided, however, that any and all sums to which the above-named officers and employees may become entitled under the terms of this resolution shall remain in the business at the risk of the business for a period of five years, and that prior to the expiration of such period said officers and employees shall be entitled to demand and receive payment of the sums to which they may become entitled only to the extent that drawings against such sum may be authorized by the president of the company, it being the intention of this resolution that any and all contingent compensation to which said officers and employees may become entitled under the terms of this resolution, be at the risk of the business in the sense that it shall be subject to pro rata deductions in the event that losses are incurred by the business during the period within which

such sums are to remain at the risk of the business; and provided, further, that no officer or employee shall at any time be entitled to withdraw any sums credited to him under the terms of this resolution, except as hereinabove provided, unless he shall remain in the employ of S. Naitove Co., Inc., during the entire period during which the credits mentioned are to remain at the risk of the business and in the event of the discharge of any such officer or employee or withdrawal during such period, all right, title, or interest of such officer or employee in or to any sums credited to said officer or employee under the terms of this resolution shall revert to this corporation.

The petitioner kept its books of account on an accrual basis of accounting and pursuant to the above-quoted resolution the following entry was made in closing the petitioner's books as of December 31, 1919, which entry was correctly computed.

Charge, selling and commission-----	\$116, 548. 44
Credit Moe Naitove-----	29, 137. 11
Nat Naitove-----	29, 137. 11
Jack Naitove-----	29, 137. 11
George Naitove-----	14, 568. 56
Moe Turman-----	14, 568. 56

additional compensation as per agreement.

The compensation provided for in the above-quoted resolution and which was accrued on petitioner's books, was reasonable for the services rendered by those employees in the year 1919.

In the year 1920, a resolution, similar to that of February 10, 1919, was passed by the petitioner's

Board of Directors, continuing the compensation for services rendered in 1920 on the same basis as authorized for services rendered in the year 1919.

In the year 1920, the petitioner suffered a loss of approximately \$90,000 and pursuant to the terms of the above-quoted resolution there was entered on the petitioner's books as of December 31, 1920, the following accruals:

Charge Moe Naitove 10%-----	\$10,441.42
Nat Naitove 10%-----	10,441.42
Jack Naitove 10%-----	10,441.42
George Naitove 5%-----	5,220.71
Moe Turman 5%-----	5,220.71
Credit surplus account-----	\$41,765.68

This entry gave effect to the participation by the five employees in the petitioner's losses for the year 1920.

Upon audit of the petitioner's return for the year 1919, the Commissioner disallowed as a deduction from gross income the amount of \$116,548.44, accrued as additional compensation to employees for that year.

Upon these findings of fact the Board approved the Commissioner's additional assessment. From the decision and redetermination of the Board, appellant has appealed to this court.

SUMMARY OF ARGUMENT

1. Appellant kept its books on the accrual basis of accounting, and pursuing that system credited on its books as of December 31, 1919, to five of its employees, the sum of \$116,548.44, which repre-

sented a portion of appellant's earnings for 1919, which was to be paid said employees, pursuant to the terms and conditions of the resolution passed by the Board of Directors of appellant. In its return for the year 1919 appellant claimed the amount thus credited on its books as a deduction from gross income. The Commissioner disallowed this deduction.

The Commissioner had the right to disallow the deductions claimed as business expenses for the year 1919, if, in fact, said expenses had not been "incurred" or had not "accrued" since it is well settled that book entries are not controlling in the determination of income. *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179. Section 212 (b) of the Revenue Act of 1918 also gave the Commissioner the right in case the method employed by a taxpayer does not reflect net income to disregard the taxpayer's method and make his own computation upon such basis and in such manner as will in his opinion clearly reflect such income.

2. Under the accrual system, an expense does not accrue until all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. *United States v. Anderson*, *United States v. Yale & Towne Manufacturing Company*, 269 U. S. 422; *Edwards v. Keith*, 231 Fed. 110 (certiorari denied 243 U. S. 638); *Aluminum Castings Co. v. Routzahn*, 24 F. (2d) 230; *Holmes Federal Taxes*, 1248 (6th Ed.).

Under the terms of the contract embodied in the resolution passed by appellant's Board of Directors, the events which were to determine and fix appellant's liability to its employees, did not occur during the year 1919. The deduction involved, therefore, did not represent an accrued expense for that year and was properly disallowed by the Commissioner.

ARGUMENT

I

Where a taxpayer kept its books on the accrual basis of accounting, items entered on its books as accrued expense are allowable as deductions in its income tax return only when they represent expenses which have been actually incurred by the taxpayer during the taxable year involved, otherwise, the Commissioner has the right to disallow such deductions

In the present case appellant kept its books on the accrual basis of accounting and pursuing that system credited on its books as of December 31, 1919, to five of its employees the sum of \$116,548.44, which represented a portion of appellant's earnings for 1919, which was to be paid to said employees pursuant to the terms and conditions of the resolution passed by the Board of Directors of the appellant. In its return for the year 1919, appellant claimed the amount thus credited to its five employees on its books as a deduction from its gross income. The deduction claimed is for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,

including a reasonable allowance for salaries or other compensation for personal services actually rendered.” Section 234 (a), Revenue Act 1918, c. 18, 40 Stat. 1057, 1077.

Since no part of the amount in question was actually paid out by appellant during the year 1919, the deduction claimed, if allowable at all, was allowable only on the theory that the amount of such deduction was “incurred” or “accrued” within the year 1919. Section 200, Revenue Act of 1918, *supra*.

The Commissioner disregarded the fact that appellant had entered the amount of deduction claimed in its return as accrued expenses on its books and disallowed the same. Thus the first question in this case is whether the Commissioner had this right. It is well settled that book entries are not controlling in the determination of income and if a taxpayer's books do not reflect true income the Commissioner is not bound by them. *Doyle v. Mitchell Brothers Co.*, *supra*. Moreover, the Revenue Act of 1918, *supra* (Sec. 212 (b)), gave the Commissioner the right in case the method employed by a taxpayer does not reflect net income to disregard the taxpayer's method and make his own computation upon such basis and in such manner as will in his opinion clearly reflect such income.

However, in this case the Commissioner conceded that the use of the accrual basis of accounting would properly reflect appellant's net income, but

did not agree that the particular items involved were properly accrued on its books or properly deducted as accrued items in its return. With respect to these items the Commissioner rejected the method of accounting employed by appellant. In effect, the Commissioner held that entering these items on its books as accrued expenses was not in accordance with or consistent with a proper use of the accrual method of accounting.

It is thus obvious that if the expenses claimed by appellant as a deduction had not in fact been "incurred" or had not "accrued" within the year 1919, even though entered as such on its books, they should not be allowed as a deduction and the Commissioner's action should be upheld. This, then, becomes the ultimate question in the case.

II

Under the accrual system an expense does not accrue until all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The sums credited on appellant's books to its employees as additional compensation were not accrued expenses for the year 1919, and the deduction claimed therefor in appellant's return was properly disallowed

Under the accrual system of accounting income is said to be accrued when it is definitely receivable, although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though

payment is not yet due. These principles were announced in the case of *United States v. Anderson*, *United States v. Yale and Towne Manufacturing Company*, *supra*, wherein it was held that munition taxes imposed by the United States accrued in the year the profits were earned although the taxes were paid in a subsequent year. The Court in that case said at page 441:

In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, *all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.* In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued. * * * (Italics ours.)

An application of these principles is found in the case of *Edwards v. Keith*, 231 Fed. 110, 112 (Certiorari denied, 243 U. S. 638) wherein there was involved the question whether income had accrued. There plaintiff, a life insurance agent, sold insurance policies under an agreement whereby he was entitled to receive a percentage of each annual renewal payment when the same was paid by

the insured. Plaintiff contended that all of the income from this source accrued at the time the policy was sold, his theory being that if it accrued prior to the Income Tax Act of 1913 (c. 16, 38 Stat. 114), he would not be taxable. The Circuit Court of Appeals for the Second Circuit rejected this contention, saying:

It may be noted that, although fully earned by work already done, there is no certainty that the sum conditionally promised for an ensuing year will ever be paid or will accrue or come due; John Doe may die within the first year, or at its expiration may refuse to renew his policy in which event the company is not obligated to pay its agent anything beyond the amount already paid him; the obligation to pay does not arise until John Doe actually pays his renewal premium in cash.

It has further been decided that profits do not accrue until they have become fixed or payable, and that liabilities do not accrue until the moment when an actual enforceable liability is created. The Supreme Court of New York in the case of *Allen v. Armstrong*, 68 N. Y. S. 1079, 58 App. Div. 427, in passing on the question of when profits may be said to have accrued, stated:

Profits may not be said to have accrued until they have become fixed or payable.
* * * The technical meaning of the word "accrue," as defined in the dictionary, is the possession of a present enforceable

right. A note is said to accrue when it becomes due and payable. Profits have accrued when they are paid or when the right to enforce payment presently exists. And "secure" means that which is presently reduced to possession or that of which payment is made sure. It is perfectly evident that a construction of these words, which attaches thereto a contingency which may or may not happen, distorts their meaning as popularly used and scientifically defined. Nor can such meaning be attached to them by any connection with language appearing in the present contract. * * *

Holmes Federal Taxes (6th Ed.) in discussing the question as to when a liability may be said to have accrued, states at p. 1248 as follows:

In construing the word "accrue," or "accrued," or "incur," or "incurred," the courts have, therefore, looked to the moment when the amount in question *becomes due*, the moment when an actual enforceable liability is created. The fixing of liability involves the making of a contract, express between the parties or implied in law. It is essential to the creation of a liability that there be between the parties concerned an agreement fixing amount, or a promise implied by law (*indebitatus assumpsit*). The liability must be fixed or determinable in amount.

It thus becomes apparent that in order that expenses may be said to be accrued, there must be more than an expectation that an expenditure will

be made, and that under the actual system of accounting liabilities or expenses can only properly be said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though the payment is not yet due.

Clearly, there can be no accrued expense until an actual liability arises. *Aluminum Castings Co. v. Routzahn, supra.*

Furthermore, the decisions of the Board of Tax Appeals in the cases of *Appeal of Block and Kohner Mercantile Co.*, 4 B. T. A. 673, and *Oliver H. Van Horn, Inc. v. Commissioner*, 9 B. T. A. 76, are not in conflict with the instant case.

A review of the facts in the *Block and Kohner case* will readily distinguish that case. In that case a written agreement between the Block and Kohner Mercantile Company and one of its employees provided that for a period of three years said employee should receive a salary of \$4,800 per year and one-third of the profits earned by said company during the continuance of the contract, with a proviso that said employee should share any losses in said business during said period. Provision was also made for the termination of the agreement upon notice or by mutual consent. It was also provided that in case of the employee's death, the right to receive salary and to the division of the profits should be terminated. The agreement also contained the fol-

lowing clause, which clearly distinguishes that case from the instant case (p. 675) :

Upon the termination of this contract, either by expiration, cancellation, or otherwise, the profits shall be figured to the date of such termination and any net losses to be shared by the parties of the second part and third part shall be deducted from the said sum of Five Thousand Dollars (\$5,000.00) deposited by the party of the third part; and the party of the first part shall pay to the party of the third part said sum of Five Thousand Dollars (\$5,000.00) so deposited, less any deductions made, as herein above stated, for losses incurred, or, if there be no losses, then plus the proper share of profits.

The point involved was whether the company was entitled to a deduction from gross income for the year 1919 of the employee's share of the net profits earned during that year, which said company had entered on its books as an accrued expense.

It is elementary that the determination of that company's income would necessarily have to depend upon facts which existed at the close of the year involved. At that time the net profits made in 1919 had accrued to it in its own right, and it would have to make return of its entire profits as income, for it could not anticipate losses that might occur in a subsequent year. However, by virtue of its contract with its employee, one-third of said net profits belonged to that employee for services rendered during that year. The employee had per-

formed in the year 1919 everything he was bound to do under the contract with the company to entitle him to a one-third share of said net profits, and his right was not dependent, as in the instant case, upon his staying with the company for the three-year period of his contract.

Therefore, since its liability to its employee was absolute and definite at the close of the year 1919, though payment was not yet due, under the doctrine of the *Anderson case, supra*, the expense had accrued in that year, and, in order to clearly reflect income, should have been allowed as a business deduction for that year.

The condition in said contract that the net profits earned in any one year should share the losses of the business during the continuation of the contract would not affect the creation of liability which had become fixed or accrued by subsequently diminishing or wiping out that liability. This condition would therefore seem to be a true condition subsequent.

The case of *Oliver H. Van Horn, Inc., v. Commissioner, supra*, is also readily distinguishable. In that case the salaries of certain employees were fixed at certain amounts for the years 1917 to 1920, which salaries were credited to said employees during the years involved though the entire amounts were not actually withdrawn. The entire amount of the salaries was not withdrawn because of an agreement which said employees had with the company that only such

amounts as were agreed upon by the Board of Directors could be withdrawn. It was further agreed that the undrawn portion of the salaries should earn interest for these employees at eight per cent per annum.

It is thus clear that the salaries credited to said employees belonged to them, and that the liability of the corporation to said employees was fixed and determined at the close of each year, which clearly distinguishes that case from the instant case. The fact that payment had not been made to them would not, as heretofore pointed out, prevent the accrual of such an expense.

Neither is the case of *American National Co. v. United States*, 274 U. S. 99, relied upon by appellant herein, in conflict. In that case the American National Company, in order to induce investors to purchase direct from the Company loan notes which it had secured from its borrowers, agreed to pay them bonuses upon the loan notes as added consideration for the purchases. The agreement was evidenced by a contract, styled a Guarantee which the Company gave the investor agreeing to pay him during the life of the loan according to the terms of the note, one per cent per annum of its amount, in addition to the five per cent per annum that the borrower was to pay. The question involved was whether or not these bonus notes were properly accrued as of the year in which they were given.

It can not be questioned that said bonus notes when given became an actual and enforceable liabil-

ity of the maker and that liability was definitely fixed in the year in which said notes were given, though payment was not then due and payable. This distinguishes that case from the instant case. Moreover, that case is in perfect accord with the *Anderson case, supra*, which defined an accrued expense. The fact that part of the bonus notes might not have to be paid in cases where borrowers paid their loan notes in advance of maturity would not change the character of the original liability.

The American National Company case also presents an entirely different situation than that involved here. In that case the company derived its income from the sale of notes. Where formerly the company had paid fees and commissions in selling its notes, it was able, by giving bonus notes instead of fees and commissions, to make direct sales of its loan notes to investors. The company's bonus notes, therefore, represented an expense of selling said loan notes as truly as the paying of fees and commissions. The entire expense incurred in connection with the sale of any given note was therefore necessarily an accrued expense in making that sale in the year in which the sale was made.

Moreover, in that case the fact that the taxpayer had entered on its books and returned as income during the year the aggregate amount of commission notes given to it by borrowers when it made the loans, was stressed by the Court. Those notes were not due in the year when given to the company, but

they were regarded and returned as accrued income. To disallow the bonus notes, which represented obligations of the company, though not due in the year made, would be inconsistent with the accrual of the borrowers' notes as income. In other words, a disallowance of the company's notes as business deductions, after the taxpayer had treated as accrued income the notes which it had received from the borrower as its commission or compensation in negotiating the loans would not have resulted in a true reflection of net income. On this point the Court said (p. 105) :

So, in the present case, we think that the amount of the bonus contracts was "an expense incurred and properly attributable" to the Company's process of earning income during the year 1917. These contracts were not analogous to obligations to pay interest on money borrowed, but were expenses incurred in selling the loan notes in as real a sense as if under its original system of doing business the Company had paid these amounts to brokers as fees for selling the loans or given them notes for such fees. The Company's net income for the year could not have been rightly determined without deducting from the gross income represented by the commission notes the obligations which it incurred under the bonus contracts, and would not have been accurately shown by keeping its books or making its return on the basis of actual receipts and disbursements. The method which it adopted clearly reflected

the true income. And, just as the aggregate amount of the commission notes was properly included in its gross income for the year—although not due and payable until the expiration of two years—so, under the doctrine of the *Anderson case*, the total amount of the bonus contracts was deductible as an expense incurred within the year, although it did not “accrue” in that year, in the sense of becoming then due and payable.

Applying the principles announced above to the instant case, it readily becomes evident that the Board’s decision is correct.

In this case the events which had to occur before there could be a fixed liability on the part of the appellant were by the terms of the resolution or proposed contract made a condition precedent to any liability whatever on the part of the appellant.

The resolution was in fact nothing more than an offer to pay additional compensation to its employees upon their performing certain acts for the corporation. In effect, appellant’s offer invited the formation of a unilateral contract which could only ripen into an obligation and become binding upon it upon performance by its employees of the acts called for in its offer. (Sec. 25, Vol. I, *Williston on Contracts*.) The resolution was passed to induce certain employees, who were contemplating leaving appellant, to remain with the business. (R. 12.) What appellant promised to pay these employees was a percentage of the profits earned during the year 1919 in consideration of their stay-

ing with the business for a period of five years thereafter. In case of death, discharge, or resignation of any of the employees, the appellant would be under no obligation to pay him or them or his or their estate anything under its contract. Moreover, the actual amounts which said employees were to receive in case they did remain with the appellant for the five-year period were not to be determined by the sums credited to them in the year 1919, for said sums were to remain at the risk of the business for said five-year period and to suffer pro rata deductions during said period in the event losses were sustained by appellant. (R. 13.)

Thus, appellant's promise was to pay that part of the profits earned during the year 1919, not consumed by losses and risks of appellant's business, which remained at the expiration of five years, provided its employees performed their part of the proposed contract by remaining in appellant's employ. Otherwise, if for any reason said employees did not remain with appellant, they would not be entitled to receive anything and appellant would not be bound to pay anything.

This was the construction placed upon the resolution by the Board. The Board in its opinion said (R. 16):

The condition in the resolution to the effect that no employee shall at any time be entitled to withdraw any sums credited to him under the terms of the resolution unless

he shall remain for five years in the employ of the petitioner, is clearly a condition precedent to the accrual of any liability.

Appellant contends (Appellant's Brief, pp. 23-24) that this construction of the Board is inconsistent with the provisions of the resolution (R. 13) which provides that withdrawal of the sums credited to the employees could be made to the extent that drawings against said sums may be authorized by the president of the company.

We do not believe there is any real merit in this contention. The provision allowing withdrawals by its employees of the sums to which *they may become entitled* only to the extent authorized by the president of the company does not *per se* vest title in those employees to the sums credited, nor make the appellant liable to pay those employees any of said sums. This condition of the resolution only permits an advance or loan to the extent authorized by the president of appellant to these employees of the sums *they may be entitled to* later on provided they perform the terms of the proposed contract. That this right to receive advances operated to create no present liability in the appellant is made apparent by the use of the words "may become entitled." This is also made clear by the proviso that "all right, title, or interest of such officer or employee in or to any sums credited to said officer or employee under the terms of this resolution shall revert to this corporation." Though no withdrawals were actually made by any

of the employees, it is nevertheless clear that if a part of the sum credited to them had been withdrawn, it would not be theirs, for it is expressly provided that the entire sums credited to them, which would include any part thereof which might be withdrawn, were only to be theirs upon the expiration of the five-year period and after they had performed their part of the proposed contract.

If this was not intended, why did not the resolution state that the employees shall be entitled to demand and receive payment of the sums "belonging to them" or "to which they are entitled" instead of saying "to which they may become entitled"? This clause of the resolution could only refer to withdrawals after the year 1919, and the words used could only have been designed to make it clear that future conditions would determine whether these employees would be actually entitled to any of the sums involved.

Appellant on its behalf urges (Appellant's Brief, p. 25) the construction that under the terms of the resolution the only condition precedent to its liability was the making of profits in the year 1919, and that when and as profits were made its liability to pay its employees their proportionate shares became fixed and properly accruable for that year.

In support of this construction, appellant argues (Appellant's Brief, p. 26) that the use of the words "may become entitled" and "shall become entitled" evidences a clear admission of liability. Particularly is this urged by the use of the term

“may become entitled” in the proviso “that any and all sums to which the above-named officers and employees may become entitled under the terms of this resolution shall remain in the business at the risk of the business for a period of five years.”

It is also urged (Appellant's Brief, p. 26) that the clause at the end of the resolution providing “that all right, title, or interest of such officer or employee in or to any sums credited to said officer or employee under the terms of this resolution shall revert to this corporation” further supports appellant's construction that its liability to its employees became fixed upon the earning of profits.

Finally it is urged that the use of the words “right, title, or interest” evidences an intent that its employees were to acquire a present vested right, title, or interest to their share of the profits when made and that the use of the word “revert” contemplates that the right, title, and interest to the compensation should vest in the employees at the end of the year 1919, subject to be defeated by the other conditions of the resolution, which it is contended are conditions subsequent.

Thus by placing its own peculiar construction on certain isolated terms of the resolution does appellant seek to prove that the construction of the Board is erroneous. The weakness of its argument is made apparent when consideration is given the resolution as a whole.

The resolution was passed with the sole intention of inducing certain employees, who were dis-

satisfied with the compensation being paid to them and were contemplating going into business for themselves, to remain in appellant's employ for five years. This was the real consideration which appellant bargained for and which primarily induced the passing of the resolution. (R. 12.)

The words used in the resolution are consistent with that intent. It is made clear throughout the resolution that said employees were not to have any right, title, or interest in the amounts credited to them unless they remained in appellant's employ for five years. The last clause of the resolution to the above effect was clearly inserted in the resolution to foreclose any claims that might be made by the employees based solely upon the entry of credit to them on appellant's books.

Neither is the proviso "that any and all sums to which the above-named officers and employees may become entitled under the terms of this resolution shall remain in the business at the risk of the business for a period of five years" inconsistent with this intent. If it had been intended that appellant's liability was to become fixed upon the earning of profits in 1919, the words "belonging to" or "are entitled" would have been used instead of "may become entitled."

Appellant's final contention as to the construction of the resolution is that the condition that the employees should stay with the company for five years is a condition subsequent to liability. It is urged that the right, title, and interest to the com-

pensation became vested as and when the profits were made and credited to the employees, subject to be defeated by the failure of the employees to remain in appellant's employ for the five-year period. (Appellant's Brief, p. 28.) This was the view of Mr. Phillips as expressed in his dissenting opinion. (R. 21.)

This contention is based upon a faulty premise and is clearly unsound. It is based upon the assumption that the employees at the end of the year 1919 had done everything required of them to earn the compensation in question. The correctness of this assumption is the real question in dispute. The appellee herein and the Board in its decision took a contrary view, namely, that under the resolution said employees could only become entitled to the sums involved upon the performance of five years of service for appellant and that the remaining in appellant's employ was a condition precedent to liability and not merely a condition precedent to payment as appellant assumes. (Appellant's Brief, p. 30.)

The contention made by appellant to the effect that said sums were properly treated as business deductions for the year 1919 is also based upon the assumption that the employees had rendered the services in 1919 for which they were to receive the sums involved herein and that the condition that the employees should remain in appellant's employ for the period of five years was a condition subsequent. (Appellant's Brief, pp. 42, 44.)

So also is the contention that if the deduction involved herein can not be taken as an expense for 1919, it can not be taken in any later year. (Appellant's Brief, p. 22.)

Neither does the finding of the Board that the sums accrued on appellant's books were reasonable compensation for the year 1919 (R. 14), establish the correctness of appellant's treating said sums as an accrued expense as contended by appellant. (Appellant's Brief, pp. 21, 32, 35, 41, 50.)

This finding of the Board was clearly an irrelevant finding, in view of the Board's construction of the resolution. It can neither be construed as a finding that said employees had earned said sums during 1919 nor as a finding that appellant had incurred a liability to pay said sums, or any part thereof, to said employees during the year 1919. The fact that reasonableness of compensation is expressly made the test of deductibility (Art. 105, Reg. 45) undoubtedly impelled the Board to make this finding, which clearly has no bearing on the issues involved herein.

The sole question in the case, as heretofore pointed out, is whether the condition in the resolution that said employees should remain in appellant's employ for five years after the year 1919 is a condition precedent to appellant's liability. If it is, then the accrual in 1919 of the sums involved was improper and appellant's return which claimed as deductions such sums for which there was no liability, did not reflect its true income for that year.

Clearly, we believe this provision of the resolution was a true condition precedent to appellant's liability, and without performance on the part of the employees appellant would not be liable to pay them any of the profits earned in the year 1919.

A condition precedent is defined by Williston on Contracts, Vol. II, Section 666a, as follows:

A precedent condition in a contract is the typical kind. It must be performed or happen before liability arises on the promise which the condition qualifies. One may also speak of a condition precedent to the existence of a contract. Acceptance is such a condition, but when the question under consideration is the construction of a contract or the duties arising under it, the term means a prerequisite to liability.

Further, it is obvious that this condition of appellant's contract is not a condition subsequent within the usual meaning of that term, as contended by Mr. Phillips in his dissenting opinion. (R. 21.) In discussing conditions subsequent, Williston in his text on Contracts, Vol. II, Section 667, says:

The term condition subsequent in contracts as used in contrast to condition precedent must mean subsequent to liability; that is, a condition which divests a liability on a contract after it has once accrued. *Such conditions are very rare.* (Italics ours.)

It is clear, therefore, that appellant's promise to pay its employees is qualified by the condition that they must remain with the business for five years, which requirement is a condition precedent to liability within the above definition of that term, and it is obvious that there could be no determined and fixed liability under the present resolution until this condition had been performed.

It is further evident that it was highly contingent and speculative whether appellant would ever incur any liability under its contract. The contract itself recognized this possibility by making reference to the sums to be paid its employees as "contingent compensation." (R. 13.) Losses suffered during the year 1920 caused the reduction of \$41,761.68 of the amount involved herein. (R. 14.) Whether losses in subsequent years reduced the credit still further, or eliminated it entirely, is not shown by the record. Neither is it shown that appellant had to pay any of its employees anything under its contract.

It is further submitted that under the circumstances it was not at all necessary for appellant to have credited on its books to its employees the items involved herein. On the contrary, it would seem to have been poor accounting practice to have done so in view of the many possible contingencies that could intervene before the expiration of the five-year period which might relieve appellant of any liability whatsoever under its contract. Irrespective of the fact that these items were accrued on

appellant's books they may, nevertheless, be properly disallowed by the Commissioner for the reasons heretofore pointed out, if in fact, they did not represent expenses which had been "incurred" or had "accrued" during the taxable year involved.

CONCLUSION

In view of the foregoing, it is submitted that the items entered on appellant's books to the credit of its employees in the year 1919 were not expenses which had been "incurred" or had "accrued" during said year within the true meaning of said terms and the deduction of such items in appellant's return rendered on an accrual basis was properly disallowed by the Commissioner, and the decision of the Board of Tax Appeals herein should be affirmed.

Respectfully submitted.

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